

McKINNEY & McPEAK, CPAs

Review Report

QUALITY CONTROL REVIEW

For the Firm's Audit of
Garvey School District
for the Fiscal Year Ended June 30, 2002



STEVE WESTLY
California State Controller

August 2005



STEVE WESTLY
California State Controller

August 5, 2005

Gordon A. McKinney, Partner
McKinney & McPeak, CPAs
1251 South Beach Boulevard, Suite H
La Habra, CA 90631

Dear Mr. McKinney:

The State Controller's Office (SCO) completed a quality control review of McKinney & McPeak, CPAs. We reviewed the audit working papers for the firm's audit of the Garvey School District for the fiscal year ended June 30, 2002.

A draft report was issued on March 30, 2005. The firm's response to the draft report is included in this final report.

If you have any questions, please contact Casandra Moore-Hudnall, Chief, Financial Audits Bureau, at (916) 322-4846.

Sincerely,

"original signed by"

VINCENT P. BROWN
Chief Operating Officer

VPB:JVB/kmm

cc: Darline P. Robles, Superintendent
Los Angeles County Office of Education
William Loose, Superintendent
Garvey School District
Arlene Matsuura, Educational Consultant
School Fiscal Services Division
California Department of Education
Jeannie Oropeza, Program Budget Manager
Education Systems, Department of Finance

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Review Report

Summary

The State Controller's Office (SCO) completed a quality control review of the audit working papers for an audit performed by McKinney & McPeak, CPAs, of the Garvey School District for the fiscal year ended June 30, 2002 (FY 2001-02). The last day of fieldwork was August 9, 2004.

The audit referred to above was performed in accordance with some elements of the standards and requirements set forth in *Government Auditing Standards*, issued by the Comptroller General of the United States, often referred to as generally accepted government auditing standards (GAGAS); U.S. generally accepted auditing standards (GAAS); Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*; and *Standards and Procedures for Audits of California K-12 Local Educational Agencies* (K-12 Audit Guide), published by the SCO. However, the majority of auditing standards and requirements were not met. The basis for our opinion is that the firm did not comply with GAAS and GAGAS with regard to general standards, fieldwork standards, and reporting standards. The firm also did not comply with OMB Circular A-133 and K-12 Audit Guide requirements with respect to performing the audit with due professional care.

Background

Any governmental unit subject to a single audit must have the audit performed in accordance with the standards referred to in this report. According to OMB Circular A-133, the auditor's work is subject to a quality control review at the discretion of an agency granted cognizant or oversight status by the federal funding agency. In addition, *Education Code* Section 14504.2 authorizes the SCO to perform quality control reviews of working papers for audits of K-12 local educational agencies (LEAs) to determine whether audits are performed in accordance with U.S. General Accounting Office standards for financial and compliance audits.

McKinney & McPeak, CPAs, is an independent certified public accounting firm with an office located in La Habra, California. The firm consists of two partners. The firm has been the independent auditor for the Garvey School District since FY 1999-2000. During FY 2001-02, the district operated two elementary (K-6) and two intermediate (7-8) schools, with a total average daily attendance (ADA) of 6,803 for the purpose of state funding.

**Objectives,
Scope, and
Methodology**

The general objectives of our quality control review were to determine whether this audit was conducted in compliance with:

- GAGAS
- GAAS
- K-12 Audit Guide
- OMB Circular A-133

The quality control review was conducted at the office of McKinney & McPeak, CPAs. We compared the audit work performed by the firm, as documented in the working papers, with the standards stated in the general objectives.

Conclusion

The audit referred to above was performed in accordance with some elements of the standards and requirements set forth in GAGAS, GAAS, OMB Circular A-133, and the K-12 Audit Guide; however, the majority of auditing standards and requirements were not met. The basis for our opinion is discussed in the Findings and Recommendations section of this report.

This report is applicable solely to the audit working papers referred to above and is not intended to pertain to any other work of McKinney & McPeak, CPAs.

**Views of
Responsible
Official**

We issued a draft report on March 30, 2005. Gordon McKinney, Partner, responded by letter dated June 27, 2005, agreeing with the review results. The firm's response is included in this final report as an attachment.

We made no changes to the findings as a result of the firm's response. Our comments regarding the firm's response are included in the Findings and Recommendations section.

Restricted Use

This report is intended solely for the information and use of the specified parties; it is not intended to be and should not be used for any other purpose. This restriction is not meant to limit distribution of the report, which is a matter of public record.

“original signed by”

JEFFREY V. BROWNFIELD, CPA
Chief, Division of Audits

Findings and Recommendations

General

The Single Audit Act and *Standards and Procedures for Audits of K-12 Local Educational Agencies* (K-12 Audit Guide), published by the SCO, require audits to be performed in accordance with U.S. generally accepted auditing standards (GAAS). These standards deal with the quality of the audits performed by the independent auditor and have been approved and adopted by the American Institute of Certified Public Accountants (AICPA). GAAS is divided into three areas: (1) general standards; (2) fieldwork standards; and (3) reporting standards. The three areas are divided into ten specific standards. In addition to GAAS, auditors of governmental entities must also perform audits in accordance with generally accepted government auditing standards (GAGAS), which expands the GAAS standards in several areas.

In the course of this quality control review, we found that McKinney & McPeak, CPAs, did not comply with the majority of GAAS and GAGAS.

In addition, the firm did not adequately document testing of the state compliance requirements of the K-12 Audit Guide and the single audit requirements for federal programs.

Noncompliance With General Standards (GAAS, GAGAS)

FINDING 1— Due professional care deficiencies

The firm did not consistently exercise due professional care in conducting the audit and in preparing related reports. Findings 2 through 11 provide several examples of the failure to exercise due professional care.

The firm did not use sound judgment in establishing the scope, selecting the methodology, and choosing and conducting tests and procedures for the audit. The firm did not document how major federal programs were selected. No written procedures were developed for two of four federal programs tested by the firm, and the firm did not document the procedures for the remaining two programs.

The audit report was not adequately supported by the working papers. There was no documentation to support the firm's conclusions for the report on compliance with requirements applicable to each major program and internal control over compliance in accordance with OMB Circular A-133, and the report on state compliance.

The working papers did not clearly document the findings and conclusions reached and were not fully supported by sufficient, competent, and relevant evidence obtained or developed during the audit. In some cases, there was no documentation of work performed in the working papers.

AU 230.1 states:

Due professional care is to be exercised in the planning and performance of the audit and preparation of the report.

AU 230.2 states:

This standard requires the independent auditor to plan and perform his or her work with due professional care. Due professional care imposes a responsibility upon each professional within an independent auditor's organization to observe the standards of field work and reporting.

GAGAS 3.26 states:

Due professional care should be used in conducting the audit and in preparing related reports.

GAGAS 3.28 states:

Exercising due professional care means using sound judgment in establishing the scope, selecting the methodology, and choosing tests and procedures for the audit. The same sound judgment should be applied in conducting the tests and procedures and in evaluating and reporting the audit results.

GAGAS 3.29 states, in part:

Auditors should use sound professional judgment in determining the standards that apply to the work to be conducted. The auditors' determination that certain standards do not apply to the audit should be documented in the working papers. . . .

The firm failed to demonstrate due professional care in conducting the audit and preparing the related reports.

Recommendation

The firm should comply with GAAS and GAGAS in performing the audit. The firm should ensure that audit reports are adequately supported by the working papers. In addition, the working papers should include all audit procedures performed and details of testing.

FINDING 2— Quality control deficiencies

The firm does not participate in an external quality control review program. An external review of the firm has never been conducted.

GAGAS 3.31 states:

Each audit organization conducting audits in accordance with these standards should have an appropriate internal quality control system in place and external quality control review.

GAGAS 3.33 states:

Organizations conducting audits in accordance with these standards should have an external quality control review at least once every 3 years by an organization not affiliated with the organization being reviewed. The external quality control review should determine

whether the organization's internal quality control system is in place and operating effectively to provide reasonable assurance that established policies and procedures and applicable auditing standards are being followed.

[NOTE 4: Audit organizations should have an external quality control review completed (that is, report issued) within 3 years from the date they start their first audit in accordance with these standards. Subsequent external quality control reviews should be completed within 3 years after the issuance of the prior review.]

Education Code Section 14503(b) states, in part:

An independent auditor shall not engage in financial or compliance audits unless, within three years of commencing the first of the audits, and every successive three years thereafter, the auditor completes a quality control review in accordance with General Accounting Office standards. . . .

Without undergoing an external quality control review, the firm cannot provide reasonable assurance that established policies and procedures and applicable auditing standards are being followed.

Recommendation

The firm should comply with GAGAS and the *Education Code* and have an external quality control review at least once every three years.

Noncompliance With Fieldwork Standards for Financial Audits (GAAS, GAGAS)

FINDING 3— Planning deficiencies

The firm did not consistently document audit planning procedures. Therefore, the SCO reviewer was unable to determine if the procedures were adequate and in compliance with professional standards.

Analytical review procedures were not adequately performed to assist in the planning of the audit. The working papers did not provide evidence that procedures were performed. The firm stated that analytical procedures were performed but were not documented in the working papers.

In planning the audit, the firm did not consider the following: (1) planned assessed level of control risk, (2) preliminary judgment about materiality levels for audit purposes, and (3) the effect of the entity's computer processing on an audit of the financial statements. There was no documentation of these procedures in the working papers. The firm stated that no formal plan was developed but the procedures were performed.

AU 311.03 states, in part:

Audit planning involves developing an overall strategy for the expected conduct and scope of the audit. The nature, extent, and timing of planning vary with the size and complexity of the entity, experience with the entity, and knowledge of the entity's business. In planning the audit, the auditor should consider, among others matters: . . .

- d. Planned assessed level of control risk.
- e. Preliminary judgment about materiality levels for audit purposes.

AU 311.05 states:

In planning the audit, the auditor should consider the nature, extent, and timing of work to be performed and should prepare a written audit program (or set of written audit programs) for every audit. The audit program should set forth in reasonable detail the audit procedures that the auditor believes are necessary to accomplish the objectives of the audit. The form of the audit program and the extent of its detail will vary with the circumstances. In developing the program, the auditor should be guided by the results of the planning considerations and procedures. As the audit progresses, changed conditions may make it necessary to modify planned audit procedures.

AU 311.09 states, in part:

The auditor should consider the methods the entity uses to process accounting information in planning the audit because such methods influence the design of internal control. The extent to which computer processing is used in significant accounting applications, as well as the complexity of that processing, may also influence the nature, timing, and extent of audit procedures. Accordingly, in evaluating the effect of an entity's computer processing on an audit of financial statements, the auditor should consider matters such as –

- a. The extent to which the computer is used in each significant accounting application.
- b. The complexity of the entity's computer operations, including the use of an outside service center.
- c. The organizational structure of the computer processing activities.
- d. The availability of data. . . .

AU 329.04 states:

Analytical procedures are used for the following purposes:

- a. To assist the auditor in planning the nature, timing, and extent of other auditing procedures
- b. As a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions
- c. As an overall review of the financial information in the final review stage of the audit

Analytical procedures should be applied to some extent for the purposes referred to in (a) and (c) above for all audits of financial statements made in accordance with generally accepted auditing standards. In addition, in some cases, analytical procedures can be more effective or efficient than tests of details for achieving particular substantive testing objectives.

Inadequate planning affects the nature, extent, and timing of work to be performed and may make the audit less effective. As a result, procedures that should be performed may be overlooked and audit risk may increase.

Recommendation

The firm should ensure that it consistently applies analytical procedures in planning audits, documents its evaluation of the district's computer processing system, and develops and documents audit procedures to be performed. The firm should ensure that the results and conclusions of all audit procedures are adequately documented in the working papers.

FINDING 4— Internal control deficiencies

The firm did not adequately document its understanding of the district's policies and procedures in relation to the control environment, accounting system, and control procedures. In addition, the firm did not consistently determine whether internal control policies and procedures had been placed in operation. Also, the firm did not assess control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements.

The firm assessed control risk at below the maximum level; however, the firm did not identify specific controls relevant to specific assertions likely to prevent or detect material misstatements. Furthermore, the firm did not perform tests of controls to evaluate the effectiveness of such controls.

The firm completed a questionnaire on procurement operations. An inquiry of cash was performed; however, there was no indication with whom it was discussed. In addition, some questions were not fully answered or explained on the questionnaire. The firm stated that the questionnaire was used only for documenting internal control and that no testing of internal control was performed.

AICPA standards and GAGAS require that auditors obtain a sufficient understanding of internal control to plan the audit and determine the nature, timing, and extent of tests to be performed.

AU 319.01 states, in part:

A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

AU 319.02 states:

In all audits, the auditor should obtain an understanding of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements and determining whether they have been placed in operation. In obtaining this understanding, the auditor considers how an entity's use of information technology (IT) and manual procedures may affect controls relevant to the audit. The auditor then assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements.

AU 319.03 states, in part:

The auditor may determine that assessing control risk below the maximum level for certain assertions would be effective and more efficient than performing only substantive tests. In addition, the auditor may determine that it is not practical or possible to restrict detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions. In such circumstances, the auditor should obtain evidential matter about the effectiveness of both the design and operation of controls to reduce the assessed level of control risk. Such evidential matter may be obtained from tests of controls planned and performed concurrent with or subsequent to obtaining the understanding. Such evidential matter also may be obtained from procedures that were not specifically planned as tests of controls but that nevertheless provide evidential matter about the effectiveness of the design and operation of the controls. . . .

AU 319.05 states:

The auditor uses the understanding of internal control and the assessed level of control risk in determining the nature, timing, and extent of substantive tests for financial statement assertions.

AU 319.25 states, in part:

In all audits, the auditor should obtain an understanding of each of the five components of internal control sufficient to plan the audit. A sufficient understanding is obtained by performing procedures to understand the design of controls relevant to an audit of financial statements and determining whether they have been placed in operation. . . .

AU 319.61 states, in part:

The auditor should document the understanding of the entity's internal control components obtained to plan the audit. The form and extent of this documentation is influenced by the nature and complexity of the entity's controls. . . .

AU 319.83 states:

In addition to the documentation of the understanding of internal control . . . the auditor should document his or her conclusions about the assessed level of control risk. . . .

GAGAS 4.30 states, in part:

AICPA standards and GAGAS require auditors to design the audit to provide reasonable assurance that the financial statements are free from material misstatements resulting from violations of laws and regulations that have a material effect on the determination of financial statement amounts. To meet that requirement, auditors should have an understanding of internal controls relevant to financial statement assertions affected by those laws and regulations. Auditors should use that understanding to identify types of potential misstatements, consider factors that affect the risk of material misstatement, and design substantive tests.

If internal controls are not adequately evaluated, internal control weaknesses may not be identified. If a control risk assessment is not performed, substantive tests may not be appropriately or adequately designed, and errors may not be detected.

Recommendation

The firm should ensure that it adequately documents its understanding of the control environment, policies and procedures for the control environment, the accounting system, and control procedures. In addition, the firm should determine and document whether internal control policies and procedures have been placed in operation. Also, the firm should ensure that it assesses and documents control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements.

FINDING 5— Errors and illegal acts deficiencies

The firm did not adequately address the AICPA standards and GAGAS for fraud and illegal acts. There were no written procedures to address this area, and nothing was noted in the working papers indicating whether consideration had been given to fraud and illegal acts in planning the audit.

AU 316.37 states, in part:

In planning the audit, the auditor should document in the working papers evidence of the performance of the assessment of the risk of material misstatement due to fraud....Where risk factors are identified as being present, the documentation should include (a) those risk factors identified and (b) the auditor's response...to those risk factors, individually or in combination....

GAGAS 4.12 states:

AICPA standards and GAGAS require the following:

- a. Auditors should design the audit to provide reasonable assurance of detecting fraud that is material to the financial statements.
- b. Auditors should design the audit to provide reasonable assurance of detecting material misstatements resulting from direct and material illegal acts.
- c. Auditors should be aware of the possibility that indirect illegal acts may have occurred. If specific information comes to the auditors' attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditors should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.

The firm did not design audit steps and procedures to provide reasonable assurance of detecting fraud and illegal acts that can directly or indirectly have a material effect on the financial statements. The firm stated that this area was reviewed but not documented.

Recommendation

The firm should comply with AICPA standards and GAGAS and design, apply, and document audit procedures to provide reasonable assurance of detecting fraud and illegal acts.

**FINDING 6—
Evidential matter
deficiencies**

We noted several instances of noncompliance with the evidential matter standard. Following are examples.

- For long-term debt, it was unclear from the working papers how the auditor determined the ending balance. The working papers did not contain the objectives, scope, and methodology of testing. We were unable to trace the amount reported to the supporting documentation.
- For compensated absences, the documentation consisted of a general long-term debt schedule of changes, which indicated the ending balance. However, there was no other supporting documentation provided indicating that the auditor tested or analyzed compensated absences.
- For self-insurance reserves, there was no documentation in the working papers of any analysis or testing performed.

AU 326.01 states:

The third standard of field work is: Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

AU 326.02 states:

Most of the independent auditor's work in forming his or her opinion on financial statements consists of obtaining and evaluating the evidential matter concerning the assertions in such financial statements. The measure of the validity of such evidence for audit purposes lies in the judgment of the auditor; in this respect audit evidence differs from legal evidence, which is circumscribed by rigid rules. Evidential matter varies substantially in its influence on the auditor as he or she develops an opinion with respect to financial statements under audit. The pertinence of evidence, its objectivity, its timeliness, and the existence of other evidential matter corroborating the conclusions to which it leads all bear on its competence.

AU 339.02 states, in part:

Working papers serve mainly to: a. Provide the principal support for the auditor's report, including his representation regarding observance of the standards of fieldwork, which is implicit in the reference in his report to generally accepted auditing standards.

AU 339.05 states, in part:

Working papers ordinarily should include documentation showing that –

- a. The work has been adequately planned and supervised. . . .
- b. A sufficient understanding of internal control has been obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
- c. The audit evidence obtained, the auditing procedures applied, and the testing performed have provided sufficient competent evidential matter to afford a reasonable basis for an opinion, indicating observance of the third standard of field work.

The accuracy of the firm’s opinion on the financial statements may be impaired when evidential matter gathered is not considered sufficient and competent.

Recommendation

The firm should comply with GAAS and ensure that adequate evidential matter is obtained and audited. In addition, the firm should document in the working papers all procedures it performed.

FINDING 7— Working paper deficiencies

We noted several instances of noncompliance with working paper standards. Following are examples.

- Working papers did not consistently contain the results of the audit tests and procedures performed.
- There were no written audit procedures for the federal compliance section. The working papers contained a questionnaire on procurement operations; however, there was no other documentation to support federal compliance testing. The working papers did not adequately support the conclusions reached, lacked necessary detail to determine the purpose, and were not cross-referenced. (Finding 9)
- The working papers did not consistently support the financial statements. The SCO reviewer was unable to trace evidence provided to supporting documentation for several account balances, which included compensated absences, long-term debt, and self-insurance reserves. (Finding 6)
- The working papers did not support the firm’s report on internal control over compliance for major federal programs. There were no audit procedures performed and supporting documentation was not provided. (Finding 8)
- The working papers did not adequately support the firm’s report on state compliance. The firm did not consistently perform the suggested audit procedures contained in the K-12 Audit Guide for the class size reduction program. (Finding 10)

AU 339.02 states, in part:

Working papers serve mainly to: a. Provide the principal support for the auditor's report, including his representation regarding observance of the standards of fieldwork, which is implicit in the reference in his report to generally accepted auditing standards.

AU 339.05 states:

Working papers ordinarily should include documentation showing that –

- a. The work has been adequately planned and supervised. . . .
- b. A sufficient understanding of internal control has been obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
- c. The audit evidence obtained, the auditing procedures applied, and the testing performed have provided sufficient competent evidential matter to afford a reasonable basis for an opinion, indicating observance of the third standard of field work.

GAGAS 4.35 states:

Working papers should contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditors' significant conclusions and judgments.

GAGAS 4.36 states:

Audits done in accordance with GAGAS are subject to review by other auditors and by oversight officials more frequently than audits done in accordance with AICPA standards. Thus, whereas AICPA standards cite two main purposes of working papers—providing the principal support for the audit report and aiding auditors in the conduct and supervision of the audit—working papers serve an additional purpose in audits performed in accordance with GAGAS. Working papers allow for the review of audit quality by providing the reviewer written documentation of the evidence supporting the auditors' significant conclusions and judgments.

GAGAS 4.37 states, in part:

Working papers should contain

- a. the objectives, scope, and methodology, including any sampling criteria used;
- b. documentation of the work performed to support significant conclusions and judgments, including descriptions of transactions and records examined that would enable an experienced auditor to examine the same transactions and records.

Without adequate documentation, the judgments made and conclusions reached are not supported.

Recommendation

The firm should ensure that working papers are prepared in accordance with GAAS and GAGAS.

Noncompliance With Federal Single Audit Requirements

FINDING 8— Federal program internal control deficiencies

The firm did not comply with federal requirements regarding the evaluation and testing of internal control over compliance for federal programs. The working papers contained a questionnaire on procurement operations; however, they did not contain adequate documentation of whether the firm performed procedures to obtain an understanding of internal control over compliance that is sufficient to support a low assessed level of control risk for major programs. In addition, the firm did not plan the testing of internal control over compliance for major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program. The working papers did not support the conclusions reached, lacked necessary detail to identify the purpose, and were not cross-referenced.

OMB Circular A-133, Section .500, states, in part:

(c) **Internal Control.** (1) In addition to the requirements of GAGAS, the auditor shall perform procedures to obtain an understanding of internal control over Federal programs sufficient to plan the audit to support a low assessed level of control risk for major programs; (2)(i) Plan the testing of internal control over major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program; and (2)(ii) Perform testing of internal control as planned. . . . (3) When internal control over some or all of the compliance requirements for a major program is likely to be ineffective in preventing or detecting noncompliance, the planning and performing of testing described in paragraph (c)(2) of this section are not required for those compliance requirements. However, the auditor shall report a reportable condition (including whether any such condition is a material weakness) in accordance with [Section] .510, assess the related control risk at the maximum, and consider whether additional compliance tests are required because of ineffective internal control.

Inadequate testing of internal control over compliance for major federal programs may result in material weaknesses or reportable conditions not being identified. In addition, without adequate testing of internal controls, the opinion expressed in the firm's report on compliance with internal control over compliance for federal programs may not be accurate.

Recommendation

The firm should comply with the requirements of OMB Circular A-133 with regard to internal control testing.

**FINDING 9—
Federal program
compliance deficiencies**

The firm did not consistently test the 14 federal program compliance requirements as required for Title I, Head Start, School Breakfast Program, and National School Lunch Program, which were major programs. For example, the firm did not test allowable costs, cash management, and reporting for each program. A questionnaire on procurement operations was used to evaluate federal compliance. The firm did not identify expenditures according to their program, and tests performed were not documented in the working papers.

OMB Circular A-133 defines 14 types of compliance requirements and the related audit objectives that the auditor shall consider in every audit. Suggested audit procedures are also provided to assist the auditor.

OMB Circular A-133, Section .500, requires:

(d) **Compliance.** (1) In addition to the requirements of GAGAS, the auditor shall determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs.

(2) The principal compliance requirements applicable to most Federal programs and the compliance requirements of the largest Federal programs are included in the compliance supplement.

(3) For the compliance requirements related to Federal programs contained in the compliance supplement, and audit of these compliance requirements will meet the requirements of this part. Where there have been changes to the compliance requirements and the changes are not reflected in the compliance supplement, the auditor shall determine the current compliance requirements and modify the audit procedures accordingly. For those Federal programs not covered in the compliance supplement, the auditor should use the types of compliance requirements contained in the compliance supplement as guidance for identifying the types of compliance requirements to test, and determine the requirements governing the Federal program by reviewing the provisions of contracts and grant agreements and the laws and regulations referred to in such contracts and grant agreements.

(4) The compliance testing shall include tests of transactions and such other auditing procedures necessary to provide the auditor sufficient evidence to support an opinion on compliance.

Without adequate compliance testing, deficiencies may not have been identified or reported. In addition, the opinion expressed in the auditor's report on compliance for major federal programs may not be accurate.

Recommendation

The firm should comply with the requirements of OMB Circular A-133 with regard to testing federal program compliance.

Noncompliance With K-12 Audit Guide Requirements

FINDING 10— State compliance deficiencies

We noted the following deficiencies with regard to K-12 Audit Guide requirements.

For the class size reduction program, the firm did not perform four of the eleven required procedures, as listed in the K-12 Audit Guide. The auditor initialed eleven audit procedures as having been performed; however, we were unable to verify that four of the procedures had been performed, based on the documentation provided.

The K-12 Audit Guide provides suggested audit procedures to be performed for each state program. The procedures are designed to determine that the applicable compliance requirements for each state program have been met.

AU 339.01 states:

The auditor should prepare and maintain working papers, the form and content of which should be designed to meet the circumstances of a particular engagement. The information contained in working papers constitutes the principal record of the work that the auditor has done and the conclusions reached concerning significant matters.

GAGAS 4.35 states:

Working papers should contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditors' significant conclusions and judgments.

GAGAS 4.37(b) states that working papers should contain:

Documentation of the work performed to support significant conclusions and judgments, including descriptions of transactions and records examined that would enable an experienced auditor to examine the same transactions and records.

The firm did not consistently perform, or adequately document, the suggested audit procedures contained in the K-12 Audit Guide for the class size reduction program. Therefore, the report on state compliance is incorrect.

Recommendation

The firm should ensure that it consistently performs the suggested audit procedures in the K-12 Audit Guide. If procedures are not performed, or if alternative procedures are performed, this should be documented in the working papers, including an appropriate justification. In addition, the firm should ensure that the procedures are performed accurately and completely, and are adequately documented in the working papers, as required by GAAS and GAGAS.

Noncompliance With Reporting Standards for Financial Audits (GAAS, GAGAS, K-12 Audit Guide)

FINDING 11— Reporting deficiencies

In its reports, the firm stated that the audit was performed in accordance with generally accepted auditing standards and government auditing standards. In addition, the audit report on major programs stated that the audit was performed in accordance with the standards contained in OMB Circular A-133. However, because the firm did not comply with all applicable standards, as evidenced by the findings in this report, the independent auditor's report, the independent auditor's report on compliance and on internal controls over financial reporting, and the independent auditor's report on compliance with requirements applicable to each major program and internal control are incorrect.

Also, the auditor's report on state compliance lists all programs to be tested for state compliance requirements, as well as the number of audit procedures for each program. The firm's report on state compliance incorrectly stated that the firm performed all of the suggested audit procedures for the class size reduction program, as noted in Finding 10.

AU 508.07 states:

The auditor's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards.

AU 508.08 states, in part:

The basic elements of the report are the following: . . .

- d. A statement that the audit was conducted in accordance with generally accepted auditing standards . . .
- e. A statement that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement
- f. A statement that the audit includes—
 - (1) Examining on a test basis, evidence supporting the amounts and disclosures in the financial statements . . .

GAGAS 5.11 states:

Audit reports should state that the audit was made in accordance with generally accepted governmental auditing standards.

GAGAS 5.12 states:

The above statement refers to all the applicable standards that the auditors should have followed during their audit. The statement should be qualified in situations where the auditors did not follow an applicable standard. In these situations, the auditors should disclose the applicable standard that was not followed, the reasons therefor, and how not following the standard affected the results of the audit.

GAGAS 5.17 states:

Auditors should report the scope of their testing of compliance with laws and regulations and of internal control over financial reporting, including whether or not the tests they performed provided sufficient evidence to support an opinion on compliance or internal control over financial reporting and whether the auditor is providing such opinions.

Education Code Section 14503(a) states, in part:

Every audit report shall specifically and separately address each of the state compliance program requirements included in the audit guide, stating whether or not the district is in compliance with those requirements. For each state program compliance requirement included in the audit guide, every audit report shall further state the suggested audit procedures included in the audit guide for that requirement were followed in the making of the audit, if that is the case, or, if not, what other procedures were followed.

If all applicable standards are not followed, and the audit reports are not modified to reflect this, the reports may be misleading and the effect on the results of the audit will not be adequately disclosed.

Recommendation

The firm should follow all applicable standards when performing audits. If applicable standards are not followed, the audit reports should be modified to disclose the standards that were not followed, the reasons, and the resulting effect on the audit. In addition, for the auditor's report on state compliance, if not all procedures were performed, the firm should provide an explanation as to why the procedures were not performed and/or a description of the alternative procedures performed.

SCO's General Comment

In its response to the draft report, the firm stated that it is aware of the deficiencies identified as a result of our quality control review. The firm indicated a willingness to implement the recommendations presented in this report. We encourage the firm to comply with all elements of the applicable standards and requirements in audits that it conducts in the future, and to ensure that its audit reports and the audit procedures it performs are adequately supported by the working papers.

**Attachment—
Firm's Response to Draft Report**



McKinney & McPeak CPA's

1251 So. Beach Blvd. • Suite H
La Habra, CA • 90631
(562) 943-0204 • FAX (562) 947-9993
<http://www.abtek.com/mmcpa>

June 27, 2005

Gordon A. McKinney, Partner
Rick L. McPeak, Partner

Cassandra Moore-Hudnall, Chief, Financial Audits Bureau
State Controller's Office, Division of Audits
P.O. Box 942850
Sacramento, CA 94250-5874

Ms. Cassandra Moore-Hudnall:

As requested, the following is a general response to the quality review comments per your draft letter dated March 30, 2005:

Response

The findings relate primarily to documentation of planning and procedural steps of tests in conjunction with the preliminary planning and fieldwork testing of the audit. The review assumes that if no documentation was found, no planning or analysis took place. Our firm's auditors routinely plan audits by analyzing the preliminary financials and their relation to prior years to determine the nature and extent of testing required. Further analysis is made from internal control questionnaires, interviews with management and results of field testing of attendance prior to the initiation of general and compliance fieldwork.

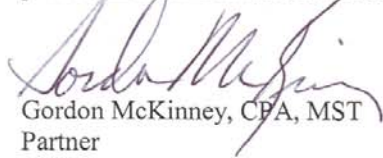
These procedures have become a matter of routine and written logs of them become a time consuming burden. While trying to keep the cost of the audit process affordable to Districts, we have shortcut some of the record keeping that makes our processes reviewable by others.

We have already instituted processes to record the planning and analysis of our government audits. We are codifying our audit procedures into company manuals and forms to be used in each audit. We are using a format set out in an educational guide called "Audits of Local Governments" as suggested by the quality reviewer. Furthermore, all audit partners will be taking the continuing education associated with this educational guide.

Our firm is reviewing our workpaper documentation to make review of documentation easier to verify. We will be using formats and techniques suggested in the aforementioned instructional audit guide. Additionally, we are including steps to

document the assessment of risk of illegal and fraudulent acts. We will budget additional time for this record keeping in our future audit bidding process. Finally, our firm is initiating the process of obtaining regular quality reviews.

We believe the above steps and procedures will assist in better documenting the audit process in a manner that can be accurately reviewed.



Gordon McKinney, CPA, MST
Partner

**State Controller's Office
Division of Audits
Post Office Box 942850
Sacramento, California 94250-5874**

<http://www.sco.ca.gov>